

## Viewpoint

### Seeking public/private partnerships for our clients

By Vivian Altman  
NJFEFA Chairwoman



Vivian Altman

Colleges and universities today face many challenges. Safe, affordable and available student housing is often at the top of the list. As enrollments grow, as campuses become more residential, as existing housing stock becomes obsolete, and as students demand upscale and technologically sophisticated living environments, housing concerns can be a focal issue for college administrations.

In recent years, the challenge of paying for dormitories and other auxiliary facilities, like athletic and parking facilities, dining halls and research facilities, has become even more difficult. This is due in part to years of declining government support which is forcing institutions to become more creative in finding alternative financing strategies for campus facilities. One growing strategy employed by colleges and universities across the country is the use of public/private partnerships in the development of student housing and other auxiliary facilities as a means to meet institutional goals.

This growing trend is reflected in George K. Baum & Co.'s list of the Privatized Student Housing Non-Recourse Financed Projects across the country as of January 30, 2006. This list includes 215 privatized housing projects in 29 states, including in those State's that are among New Jersey's greatest regional

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## Overview of NJFEFA's 2006 transactions



*Rendering of Montclair State University's Student Recreation Center*

Since January, NJFEFA has completed ten stand-alone transactions providing more than \$430 million in financing for nine of New Jersey's institutions of higher education. Roughly half of the total par amount of financing to date, or \$231 million, has provided funding for new capital projects at Montclair State University, Ramapo College of New Jersey, Caldwell College, and Princeton University.

The year's activity has also included a number of refunding transactions. Eight of the ten stand-alone deals have financed refundings or partial refundings totaling over \$199 million and have provided a combined net present value savings of approximately \$10 million to participating institutions.

Among NJFEFA's new money transactions was the Series 2006 A bonds sold in the amount of \$98.09 million on behalf of Montclair State University. MSU will use these bond proceeds to finance new capital projects on campus which will include the construction of a new student recreation cen-

ter (pictured inset), a 2,000 space parking structure and renovation of Panzer Gymnasium. Other projects funded through this bond sale include an addition to and renovation of Chapin Hall and renovation of Mallory and Finley Halls, all of which are academic buildings on campus.

NJFEFA has also seen an increased interest this year in forward starting swaps. The current attractiveness of these structures is due to the expectation that interest rates will rise in the future, and the attractive pricing of forward premia in today's market. Several of NJFEFA's clients, including Seton Hall University, have entered into forward starting swap agreements that have allowed the institution to lock in today's favorable rates in anticipation of a future bond transaction.

In Seton Hall's case, NJFEFA sold \$20,750,000 revenue refunding bonds in May of this year. Issued as Auction Rate Securities, the 2006 Series A transaction was a variable rate current refunding of the

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## A tradition of client service

By Roger L. Anderson, NJEFA Executive Director

2006 is the 40th anniversary of NJEFA. We who work for the Authority are fortunate to be part of a tradition of client service that began that first day back in 1966, and we use this anniversary to pay tribute to all our predecessors who established and carried on that tradition.

As we honor our past, we also look to the future, for it is our obligation to carry on the tradition of client service. New Jersey's colleges and universities face the challenges of ever-changing circumstances and NJEFA must be prepared to help our clients meet those challenges.

As Kathy Clupper writes on page 3, those changing circumstances include the increasingly common use of derivative products in the municipal finance marketplace. It is therefore appropriate that many of NJEFA's more recent client-service initiatives relate to derivatives. Mary Jane Darby describes, on page 4, one new product, developed in response to unusual market conditions, that is finding increasing popularity across the country.

NJEFA is pleased to be able to bring market opportunities to the attention of our clients, but we also have broader initiatives.

Last fall, NJEFA adopted a Swap and Derivative Policy to promote the careful and informed use of derivatives by the Authority and our clients. To our knowledge, it was the first derivatives policy adopted by a conduit issuer anywhere in the country.

One of the central tenets of the Swap and Derivative Policy is the need for education. In May, we participated on a panel on understanding interest rate swaps at the Government Finance Officers Association's (GFOA) Annual Conference in Montreal. Swaps education must expand beyond just explaining what swaps are to how they work. Users will be able to evaluate better the potential risks and benefits of swaps if they understand how swaps work, and therefore we dared to introduce a little math into the panel. We believe that finance officers are more likely to be comforted, than scared, by equations.

We are also participating in GFOA's project to develop a derivatives checklist that will help users that are relatively new to the

derivatives market assure themselves that they have considered all the relevant issues in a transaction. In addition, we testified before the Government Accounting Standards Board on its Preliminary Views on Accounting and Financial Reporting for Derivatives. Because derivatives are typically used in the municipal market in conjunction with bond issues, our focus in the testimony was on hedge accounting, which would treat a derivative and a bond deal together.

NJEFA's Swap and Derivative Policy also called for the appointment of a Swap Monitor, which we accomplished in July. The Swap Monitor will work with our clients for the lives of their derivatives, confirming payment amounts, calculating market values and monitoring ratings and collateral levels.

Because we believe this work is so valuable to our clients, NJEFA is picking up the fees of the Swap Monitor.

Our efforts to provide more value to colleges and universities also extend beyond swaps and derivatives. As our Chair discusses on page one, an area of rising interest is the possibility of public/private partnerships as a means of leveraging funds in the development of campus facilities. NJEFA is working to get legislation passed that will allow us to expand the kinds of financing we can offer, so we can bring the financial flexibility offered by these partnerships to New Jersey's colleges and universities.

We have also become involved in a project to clarify record-keeping requirements under federal tax law. Given the increased focus of the IRS on postissuance compliance with tax requirements, as described by Kathie Newell on page 5, we believe this project is timely.

We enjoy the challenge of living up to NJEFA's tradition of client service, and we look forward to doing even more to support New Jersey's colleges and universities in their drive to provide the best education to more students than ever before.



*Roger L. Anderson*

*As we honor our past,  
we also look to the future,  
for it is our obligation to  
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client service.*

# Trends in higher education financing



By Katherine Clupper, Senior Managing Consultant, Public Financial Management, Inc.

The first half of 2006 has seen a marked decline of debt borrowings in the municipal market, largely due to the lack of bond refundings. Through July 2006, municipal bond issuance was estimated to be over \$206.6 billion. This is a 15.5% decrease from \$244.5 billion issued in the previous year's period. However, new money issuance has increased by 13.5%.

Higher education debt borrowings nationally have also declined. Issuance volume in the first half of 2006 was \$12,411,800,000 in 325 issues compared to \$16,044,700,000 in 414 issues during the same period in 2005, representing a percentage change of -22.6%. Even though total issuance is down in the national higher education market, new money borrowings seem to be remaining constant, mimicking the trend in the overall bond market. With increasing student demand, higher education institutions must continue to attract students with investments in their infrastructure, technology advances and increased availability of student housing. This need for capital is presenting opportunities for new structures and approaches to the traditional financing strategy of fixed rate tax-exempt bonds.

One of these trends is the increased use of variable rate debt, both in the form of auction rate securities and long-term, variable rate debt. Auction rate securities increased to \$7 billion or 68.7% over the same time period last year for all education financings. The use of Standby Purchase Agreements increased 144% or \$1.9 billion and Letters of Credit increased by 12.1% or \$1.79 billion.

This strategy of diversification of an issuer's debt portfolio is more than just taking advantage of the low cost of borrowing in the short term

market. Colleges and universities are also taking advantage of the booming municipal derivatives market as a means to more efficiently hedge their floating rate exposure. This market activity has also resulted in increased pricing competitiveness for liquidity and credit facilities, making issuing variable rate bonds much more cost effective than in the past.

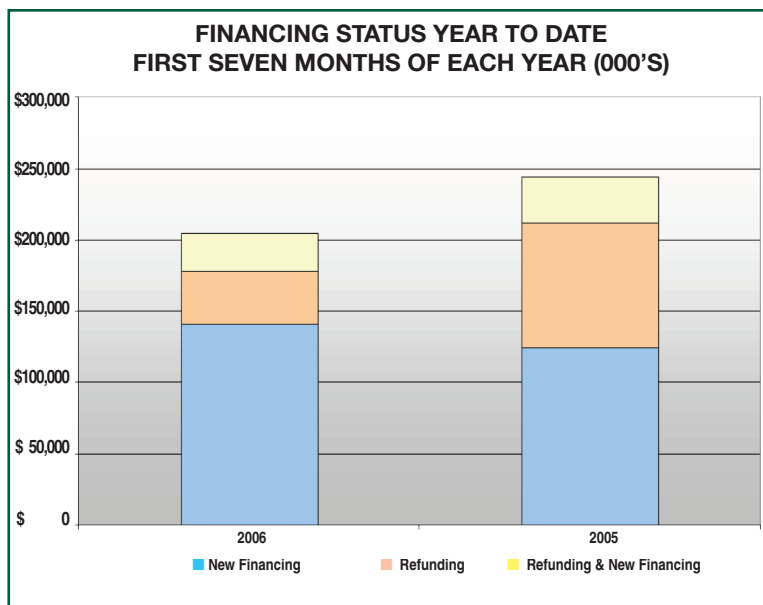
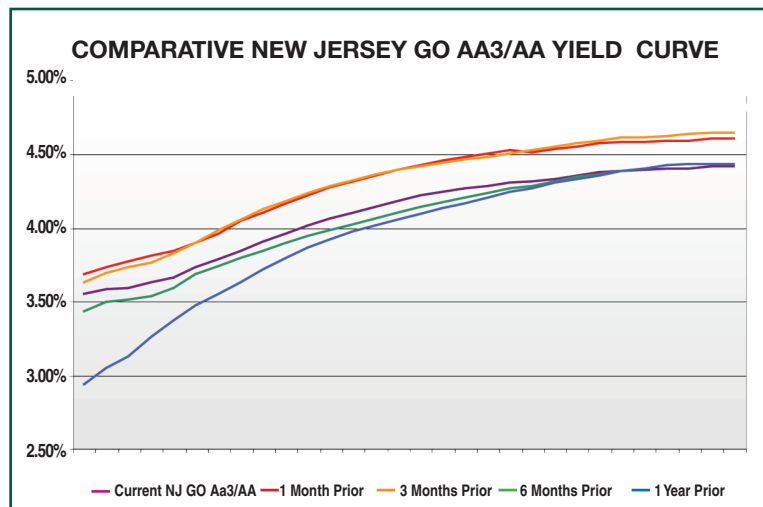
All of this is occurring while the insured bond market has decreased significantly or 30% in the first six months of 2006. This lower volume, coupled with the increased number of bond

"AAA" insurers are decreasing on fixed-rate deals and are almost nonexistent for auction rate securities. This creates an opportunity for universities and colleges to obtain "AAA" insurance that could not previously. It also increases the availability of "AA" insurance to smaller less credit worthy institutions. All of this serves to increase the options available to colleges and universities for funding their future capital needs.

Another expanding trend in the higher education marketplace is use of public/private partnerships in student housing financing. One advantage of these ventures is they shorten the time period to complete the projects. They also may have a limited impact on the credit profiles of the institutions depending on their structure. The off balance sheet structure is attractive for public and private universities facing low debt capacity, sluggish endowment growth and increasing capital needs. Many universities are creating private foundations for the exclusive purpose of providing housing.

These financing trends confirm the reality of the future of higher education. With the pressure from decreasing state funding for public institutions and student grants and loans and the increased student demand, alternative financing structures and diversity in debt portfolios will be needed along with the need for alternative funding sources and revenue streams. Colleges and universities will continue to take advantage of these trends or opportunities to diversify their debt portfolios and to finance projects by taking advantage of public/private partnerships. Those that incorporate these approaches in

a well planned capital planning strategy will be one step ahead of the game.





# Market opportunities in derivatives

By Mary Jane Darby<sup>1</sup>, NJEFA Director of Project Management

Since late March, the tax-exempt municipal market has been very active with swap restructuring strategies designed to increase the cashflow from LIBOR based swaps, and more recently from BMA based swaps. These transactions, most commonly referred to as Constant Maturity Swaps, generally entail the restructuring of an existing swap or the layering on of a new swap. In either case, the strategy is designed to achieve significant cashflow and other benefits over the term of a swap. Instead of receiving a variable rate payment based on a short-term LIBOR/BMA reference, the basis of the receipt is changed to a longer term LIBOR/BMA reference.

The current attractiveness of a restructuring transaction is due to the present flatness of the yield curve. Using LIBOR based swaps as an example, there is very little difference (as few as 10-15 basis points) between one-month and ten-year LIBOR. However, the average difference between one-month and ten-year LIBOR has been approximately 190 basis points. Since the yield curve is normally upward sloping, the anticipation is that the upward bias of the curve will return at some point resulting in significantly higher cashflow receipts using the longer term LIBOR. The risk that is assumed in these restructuring transactions is yield curve risk, or in other words, risk that the shape of the yield curve remains flat or inverts for any significant period of time. While this has not been the norm, this could result in negative cashflows.

In April, NJEFA's Board authorized staff to make such swap restructuring opportunities available to its clients. In

recent months, NJEFA staff has worked with several institutions, including New Jersey City University (NJCU) and The Richard Stockton College of New Jersey (Stockton College) to implement restructuring strategies that may create opportunities to achieve significant cash flow benefits over the terms of their respective swaps. Using NJCU as an example, if the shape of the yield curve returns to the norm, the University could potentially receive an average annual cashflow benefit of approximately \$575,000. Similarly, the potential average annual benefit for Stockton College is

an existing swap to exchange the receipt. Either method enables the cashflow receipt of the borrower to change from a short-term LIBOR to a long-term LIBOR. A similar effect can be created for those without existing swaps with a new swap under which the borrower pays the short-term rate and receives the long-term rate.

The historical analysis of this restructuring demonstrates that while the current cashflow would actually result in a small negative result, since 1990 the average net benefit to the borrower has been approximately 83 basis points. This

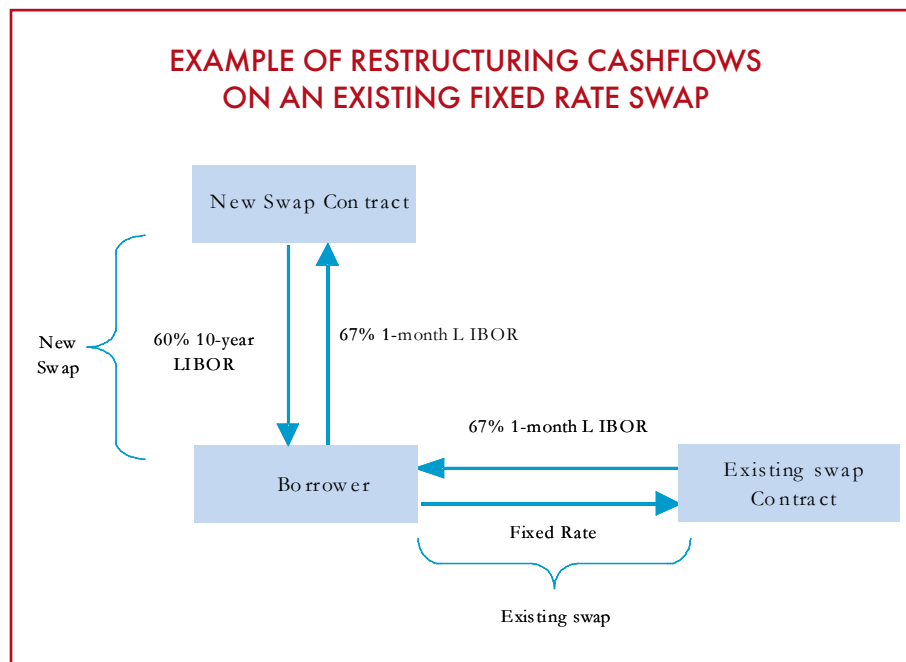
net benefit is effectively the difference between 67% of the 16 year average of 1 month LIBOR and 60% of the 16 year average of 10 year LIBOR. While this transaction has not generated positive cashflows in every year of the analysis, the overall benefit has been significant.

This same restructuring is now also available to those borrowers with BMA swaps and the historical analysis, while only 12 years of data is available, also shows significant

positive cashflow benefits averaging approximately 90 basis points. While these restructurings may not be for every borrower, those with the ability to cover short term cashflow differentials could benefit over the long term.

For more information on these and other derivative related strategies contact NJEFA's Director of Project Management, Mary Jane Darby at 609.987.0880.

<sup>1</sup> Ms. Darby appreciates the help of IMAGE, NJEFA's derivatives adviser, in preparing this article.



\$140,000.

The chart inset, provides a cashflow restructuring example utilizing a borrower with an existing 67% of one-month LIBOR fixed rate swap. This example entails layering on an additional swap in which the existing receipt of 67% of 1-month LIBOR is paid by the borrower to the counterparty (effectively canceling out the existing receipt) and the receipt on the new swap would be 60% of 10 Year LIBOR. The same effect can be accomplished by amending

# Recent tax developments

By Katherine Newell, Esq., NJEFA Senior Advisor

The Internal Revenue Service recently announced a new audit program for tax-exempt bonds, requested comments on record retention requirements and placed guidance relating to private use and arbitrage on its list of priority projects.

## NEW IRS AUDIT PROGRAM

In May, the IRS announced a new program to audit Section 501(c) (3) bonds, concentrating on housing, economic development and health care financings. Post-issuance compliance will be the IRS's primary focus. IRS representatives have emphasized the need to maintain records about management, food service, research and other types of contracts that can result in private use and in investment of bond proceeds. The bond community anticipates that the IRS will apply the information it obtains about the quality of compliance and recordkeeping to higher education and other types of financings.

## COMMENTS ON RECORD KEEPING REQUIREMENTS

Although the IRS has prescribed some specific record keeping requirements for tax-exempt bonds, in general, the IRS looks to general rules which apply for all federal tax matters. These general rules require that books and records be retained "so long as the contents hereof may become material in the administration of any internal revenue law".<sup>1</sup>

Since bond issues may be outstanding 30 years or more, maintaining records can impose a significant administrative burden. The IRS has requested comments "for developing record retention standards, including recordkeeping limitation programs, for tax-exempt bond issues"<sup>2</sup> and has specifically invited comments on managing any burdens potentially associated with the record retention requirements for tax-exempt bonds.

It may be difficult to obtain time limits on record retention for some areas of tax compliance. One example involves substantiating private business use, which is one focus of the new IRS audit program. However, there are other areas where some limits may be possible. For example, in a report dated June 8, 2005 (the "ACT Report"), the Advisory Committee to the Treasury Department on Tax

Exempt and Government Entities suggested that records for rebate calculations will be sufficient if they are retained for three years after rebate is paid instead of three years after maturity of a bond issue. In the ACT Report, the Committee pointed out the need for clarification of what records are "material." The Committee also suggested that summaries of information about tracking expenditures and investments rather than underlying invoices and confirmations should be permitted and proposed that certifications or agreements with the IRS relating to record retention be considered.


The Government Finance Officers Association and the National Association of Bond Lawyers are preparing comments on record retention for submission to the IRS and the Authority is participating in these projects. If you are interested in commenting or would like additional information, please contact NJEFA Senior Advisor, Katherine Newell. The IRS has requested written comments no later than October 26, 2006.

## PRIORITY PROJECTS

IRS priority projects include proposed regulations on allocation of, and accounting for, private activity bond proceeds, guidance on private business use stemming from federal financing of research and the 1980 Bayh-Dole Act, and guidance on arbitrage.

In a recent article in *The Bond Buyer*, Treasury and the private sector discussed these IRS regulatory projects. According to the article, Treasury expects the regulations relating to private activity bond proceeds to define how "mixed use" facilities with governmental and private business use can be financed with tax-exempt bonds. In addition, a new safe harbor is expected to modify the current safe-harbor rules for research contracts so that contracts entered into by universities and research institutions under the Bayh-Dole Act (which allows researchers to retain title to federally funded patents) do not create private business use. And, as reported in the article, the arbitrage project is intended to clarify some ambiguities in existing regulations and is likely to address technical rules related to swaps and long-term working capital.

Clarification for these private business use

and arbitrage issues should prove helpful for tax-exempt higher education financings since colleges and universities are more frequently considering public/private partnerships and use of swaps and other derivative products. 

<sup>1</sup> Treasury Regulations Section 1.6001-1 (e).


<sup>2</sup> Notice 2006-63.

## Viewpoint, continued from page 1

competitors for students: New York, Delaware, Pennsylvania and Maryland.

NJEFA is currently working with the State Legislature on statutory amendments that would enable NJEFA to provide financing to a non-profit foundation or an affiliate of a college or university, which is a necessary component for the development of these partnerships on a tax-exempt basis.

Public private partnerships can offer numerous benefits to institutions. In March, Standard and Poor's published *Public-Private Partnerships Advance U.S. Higher Education Student Housing Projects*, a report that focused on the expansion of this market and the benefits of such partnerships. S & P stated that "a major appeal ... is the ability to circumvent traditional financing conditions, offering the benefit of significantly reducing the length of time to complete the project and the project costs."


NJEFA's success over 40 years has been predicated on our ability to help our clients meet their long-term fiscal goals through low-cost capital for campus facilities and infrastructure. Our work has demanded financial flexibility, creativity and the ability to adjust our services along with the needs of our industry and the growing complexity and sophistication of the capital markets. It is our hope that our proposed amendments authorizing financing of public/private partnerships will be considered by the Legislature this fall. 



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## NJEFA's '06 activity, continued from page 1

University's outstanding 1996 Series E bonds. In anticipation of this transaction back in 2005, the University entered into a forward starting swap agreement with Citibank, N.A., in August of 2005, to lock in the swap rate the University would pay upon issuance of the 2006 Series A refunding bonds. Under the terms of the swap agreement, the University will pay 3.433% to Citibank, N.A., and will receive 69% of LIBOR. The total net present value savings from the transaction for the University was almost \$2.4 million, or just over 12.5% of refunded par.

For the remainder of the year, NJEFA anticipates completing at least an additional four more transactions with an estimated \$133 million in combined total par amount of financing. In addition, consistent with national trends for higher education financing noted in Katherine Clupper's article on page 3, we anticipate that the total par amount of financings in 2006 will have decreased compared to 2005's record activity in which we closed nearly \$1 billion in financings. 

### NJEFA ISSUES CLOSED IN 2006

INSTITUTION	PROJECT	CLOSING	AMOUNT
<b>PRIVATE</b>			
Princeton University	Capital Improvements	6.01.06	\$74,290,000
Seton Hall University	Refunding	6.01.06	\$20,750,000
Fairleigh Dickinson University	Refunding	6.29.06	\$16,652,544
Felician College	Refunding	6.30.06	\$11,445,000
Institute for Advanced Study	Refunding	7.19.06	\$29,600,000
Caldwell College	Refunding; Residence Hall	7.20.06	\$21,400,000
Princeton University	Refunding	8.10.06	\$93,285,000
<b>PUBLIC</b>			
New Jersey City University	Refunding	2.16.06	\$5,950,000
Ramapo College of New Jersey	Academic building; Phase IX Housing, parking garage; completion of Sustainability Education Center; infrastructure improvements; renovation of athletic fields	3.30.06	\$59,086,000
Montclair State University	Student recreation center; parking structure; addition and renovation of Chapin Hall; renovation of Finley Hall, Mallory Hall and Panzer Gymnasium; refunding	7.06.06	\$108,060,000
<b>GRAND TOTAL</b>			<b>\$430,517,544</b>